The Market for Financial Adviser Misconduct

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Financial Advice

Financial advisers/ brokers

- 650,000 financial advisers in the U.S.
- 10% employment in Finance and Insurance sector
- 56% of American households use an adviser (2010 SCF)

Perceived as dishonest

- 48% of Americans think finance hurts the U.S. economy while only 34% think it helps (Chicago Booth-Kellogg School Financial Trust Index)
- Financial industry ranked among the lowest when ranked on "trust to do the right thing"

▸ Trust Barometer

"I fear that in the financial sector fraud has become a feature and not a bug" -(Zingales AFA address)

- Systematic evidence?

- How widespread and persistent is misconduct
  - ▶ Advisers
  - ▶ Firms

- Are bad advisers forced out?
  - ▶ Firm
  - ▶ Industry
  - ▶ Labor market for bad financial advisers

Data

Universe of financial advisers

- 2005-2015
- 650k active advisers,1.2mm total advisers
- Over 7mm adviser by year observations
- Observe
  - Employment history
  - Registrations, qualifications, etc.
  - Disclosures

Universe of brokerage firms

- Over 62,000 firm by year observations
- Observe
  - Customer base
  - Size
  - Location
  - Organizational structure
  - Management

Data: Sources

- Other financial advisory/brokerage firm data sources
  - Form ADV
  - LinkedIn
  - Industry surveys on salaries, assets, revenues, etc.

- County Demographic Data
  - 2010 Census
  - 2010-2013 American Community Survey

John Doe

This broker is not currently registered.

Report Summary for this Broker

This report summary provides an overview of the broker's professional background and conduct. Additional information can be found in the detailed report.

Broker Qualifications

This broker is not currently registered.

This broker has passed:
- 0 Principal/Supervisory Exams
- 1 General Industry/Product Exam
- 2 State Securities Law Exams

Registration History

This broker was previously registered with the following securities firm(s):

INTERNATIONAL ASSETS ADVISORY, LLC
CRD# 10645
ORLANDO, FL
05/2013 - 06/2014

SECURITIES AMERICA, INC.
CRD# 10205
CHARLOTTESVILLE, VA
03/2013 - 04/2013

CAMBRIDGE INVESTMENT RESEARCH, INC.
CRD# 39543
CHARLOTTESVILLE, VA
06/2010 - 04/2013

Disclosure Events

All individuals registered to sell securities or provide investment advice are required to disclose customer complaints and arbitrations, regulatory actions, employment terminations, bankruptcy filings, and criminal or civil judicial proceedings.

Are there events disclosed about this broker? **Yes**

The following types of disclosures have been reported:

Type	Count
Investigation	1
Customer Dispute	2
Termination	2

Investment Adviser Representative Information

The information below represents the individual's record as a broker. For details on this individual's record as an investment adviser representative, visit the SEC's Investment Adviser Public Disclosure website at

http://www.adviserinfo.sec.gov

Data: Example

Customer Dispute - Settled

This type of disclosure event involves a consumer-initiated, investment-related complaint, arbitration proceeding or civil suit containing allegations of sale practice violations against the broker that resulted in a monetary settlement to the customer.

Disclosure 1 of 1

Reporting Source: Firm

Employing firm when activities occurred which led to the complaint: STATE FARM VP MANAGEMENT CO.

Allegations: ALLEGATIONS INDIVIDUAL STOLE MONEY FROM CUSTOMER'S ACCOUNTS, OPENED ACCOUNTS IN CUSTOMER'S NAME WITHOUT HER KNOWLEDGE AND CONSENT, AND FRAUDULENTLY USED CUSTOMER'S DEBIT CARD. ACTIVITY IS ALLEGED TO HAVE OCCUREED BETWEEN JULY 8, 2008 AND APRIL 28, 2011.

Product Type: Annuity-Fixed
Banking Products (other than CDs)
Mutual Fund

Alleged Damages: $0.00

Alleged Damages Amount Explanation (if amount not exact): NO SPECIFIC AMOUNT CLAIMED. DAMAGES ALLEGED WOULD BE IN EXCESS OF $5,000.

Monetary Compensation Amount: $40,000.00

- Is misconduct bug or feature of financial advice?
  - ▸ Measuring misconduct
 - ▸ Prevalence of misconduct in the industry

- Differences across
  - ▸ Advisers
  - ▸ Firms

Measuring Misconduct

Disclosure	Disclosure/Misconduct	
	Current	Current and Past
Misconduct Related Disclosures:		
Customer Dispute - Settled	0.317%	3.71%
Employment Separation After Allegations	0.183%	0.98%
Regulatory - Final	0.096%	1.23%
Criminal - Final Disposition	0.025%	2.05%
Customer Dispute - Award/Judgment	0.017%	0.57%
Civil - Final	0.003%	0.03%
Any Misconduct Related Disclosure	0.603%	7.28%
Other Disclosures:		
Financial - Final	0.348%	2.10%
Customer Dispute - Denied	0.311%	3.20%
Judgment/Lien	0.215%	1.00%
Customer Dispute - Closed-No Action	0.072%	0.96%
Financial - Pending	0.058%	0.20%
Customer Dispute - Pending	0.057%	0.28%
Customer Dispute - Withdrawn	0.016%	0.17%
Criminal - Pending Charge	0.009%	0.02%
Investigation	0.009%	0.03%
Regulatory - Pending	0.004%	0.01%
Civil - Pending	0.004%	0.01%
Customer Dispute - Final	0.002%	0.02%
Customer Dispute - Dismissed	0.001%	0.01%
Civil Bond	0.001%	0.02%
Regulatory - On Appeal	0.001%	0.00%
Criminal - On Appeal	0.000%	0.00%
Civil - On Appeal	0.000%	0.00%
Any Disclosure	**1.620%**	**12.73%**

Misconduct is not Frivolous
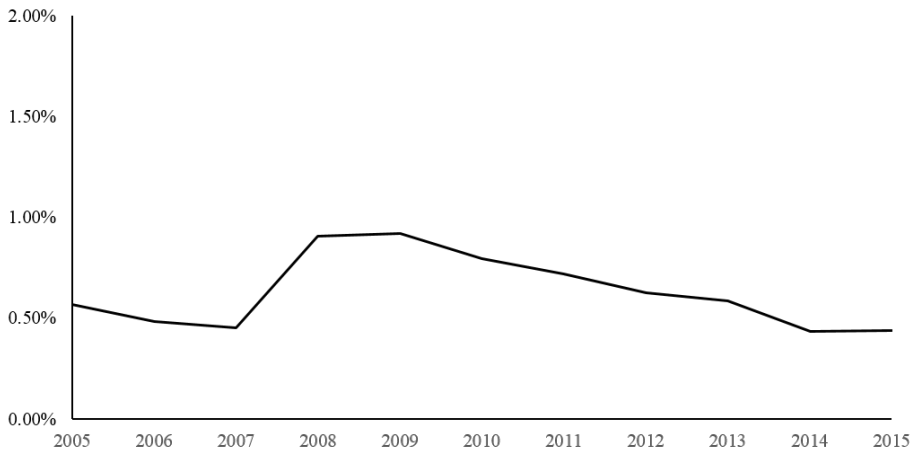## Distribution of Damages
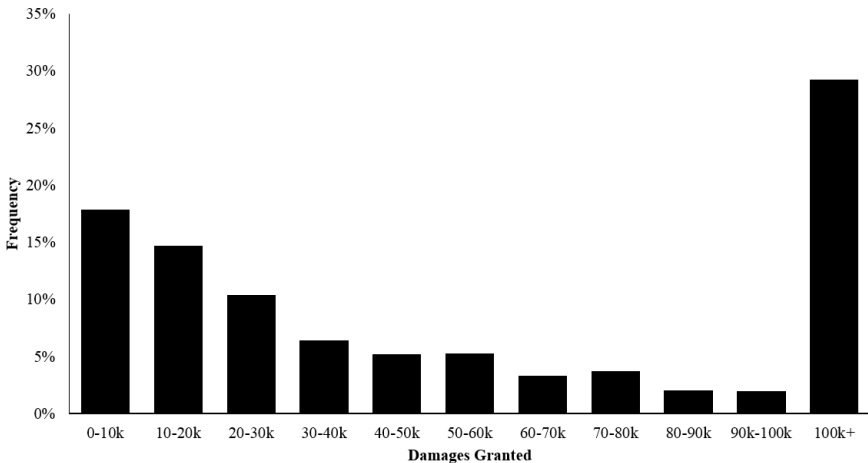
Median: 40,000

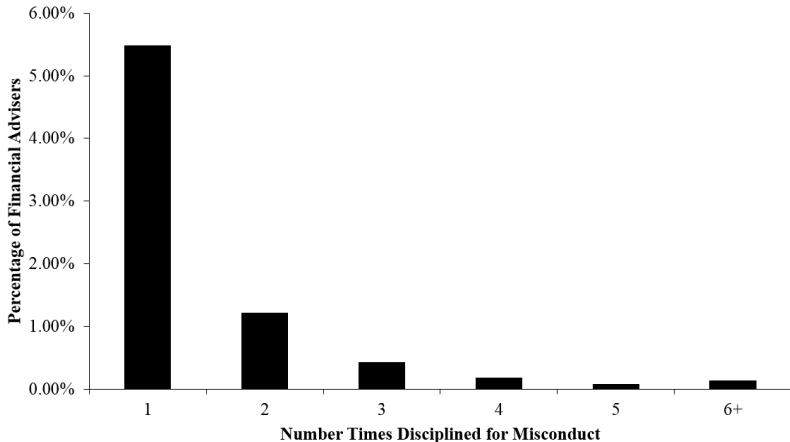## Percentage of Financial Advisers Disciplined in Each Year

Misconduct Among Financial Advisers
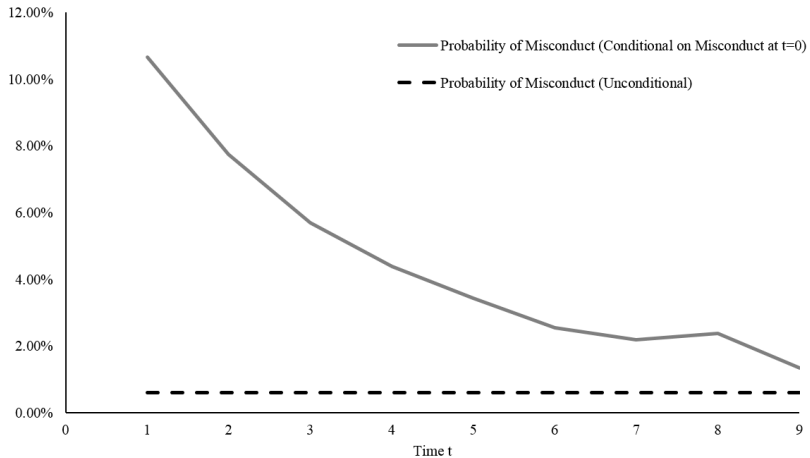## Repeat offenders

If past misconduct predicts future misconduct:

- Reason to discipline past misconduct
- Not consistent with swift and harsh punishment

Misconduct Among Financial Advisers
Long lived

Misconduct Among Financial Advisers
Repeat offenders

$$Misconduct_{ijlt} = \alpha PriorMisconduct_{ijlt} + \beta X_{it} + \mu_{jlt} + \varepsilon_{ijlt}$$

	(1)	(2)	(3)
Prior Misconduct	0.0240***	0.0227***	0.0190***
	(0.001000)	(0.000959)	(0.000735)
Adviser Controls		X	X
Year×Firm×County F.E.			X
Observations	7,946,680	7,946,680	7,689,495
R-squared	0.006	0.007	0.093

Misconduct: Variation Across Firms
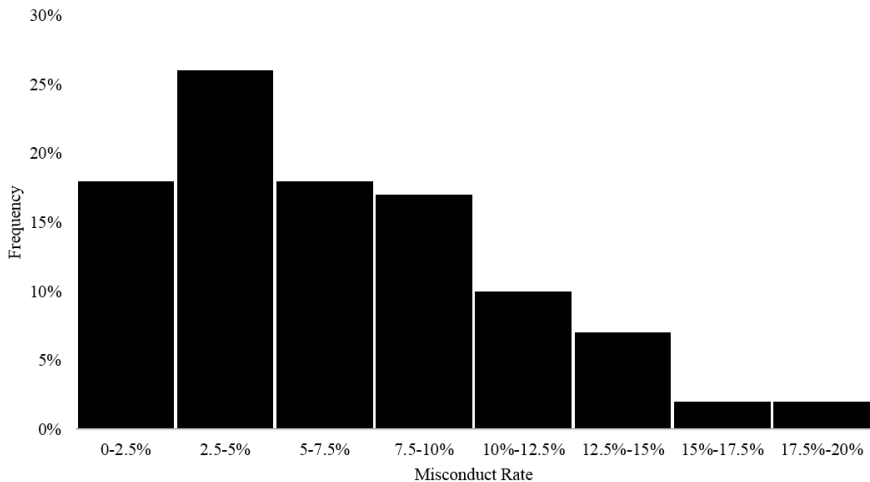
Percentage of advisers at each firm that have been disciplined for misconduct (restricted to firms with 1000+ advisers)

Misconduct: Variation Across Firms

Rank	Firm	Misconduct Rate	# Advisers
1	OPPENHEIMER & CO. INC.	19.60%	2,275
2	FIRST ALLIED SECURITIES, INC.	17.72%	1,112
3	WELLS FARGO ADVISORS FN	15.30%	1,797
4	UBS FINANCIAL SERVICES INC.	15.14%	12,175
5	CETERA ADVISORS LLC	14.39%	1,432
6	SECURITIES AMERICA, INC.	14.30%	2,546
7	NATIONAL PLANNING CORPORATION	14.03%	1,760
8	RAYMOND JAMES & ASSOCIATES, INC.	13.74%	5,495
9	STIFEL, NICOLAUS & COMPANY, INC.	13.27%	4,008
10	JANNEY MONTGOMERY SCOTT LLC	13.27%	1,394

(a) % of Advisers Disciplined for Misconduct

Company "has made significant investments to proactively tackle risk and compliance issues in our private client division. We've made changes in senior leadership, branch managers, and significant changes in our advisor ranks."
Source: Bloomberg

- Misconduct common and widespread (1/13 advisers)

- Large share of repeat offenders: Past misconduct predicts future misconduct

- Large and persistent differences across firms

Consequences of Misconduct?

Large share of repeat offenders

What happens to financial advisers after misconduct?

- Stay with the firm
- Leave the firm
  - ▸ Leave the industry
  - ▸ Switch firm

Switch firm:

- Duration of unemployment
- Quality of new job

How often do financial advisers leave the industry or switch firms?

	No Misconduct	Misconduct
Remain with the Firm	81%	52%
Leave the Firm	19%	48%
Leave the Industry	48%	56%
Join a Different Firm (within 1 year)	52%	44%

$$Job\_Separation_{ijlt} = \alpha \, Misconduct_{ijlt-1} + \beta X_{it} + \mu_{jlt} + \varepsilon_{ijlt}$$

	(1)	(2)	(3)
Misconduct	0.293***	0.308***	0.244***
	(0.0169)	(0.0162)	(0.0182)
Adviser Controls		X	X
Year×Firm×County F.E.			X
Observations	7,278,974	7,278,974	7,041,116
R-squared	0.004	0.011	0.326

$$New\_Employment_{ijlt} = \alpha Misconduct_{ijlt-1} + \beta X_{it} + \mu_{jlt} + \varepsilon_{ijlt}$$

|	(1)	(2)	(3)
Misconduct	-0.0847**	-0.128***	-0.0953***
	(0.0248)	(0.0153)	(0.0111)
Adviser Controls		X	X
Year×Firm×County F.E.			X
Observations	1,375,641	1,375,641	1,265,813
R-squared	0.000	0.125	0.374

- Condition on advisers with observed settlements and awards

- Compare two advisers w/ misconduct in same firm x time x county

- Larger settlement:
  - More firing
    - 25th to 75th change: $10pp$
  - More industry exit
  - Less re-hiring

- Do 44% escape without punishment?
  - Unemployment duration
  - New employment quality

- Who hires them?
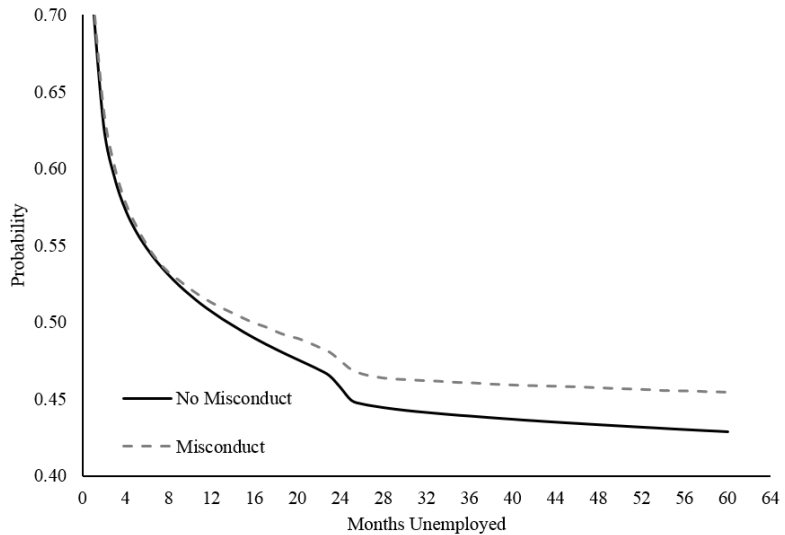
$$\lambda_i(\tau) = \lambda_0(\tau) exp(\beta\, Misconduct_{it} + \beta X_{it} + \mu_t)$$

	(1)	(2)
Misconduct	0.828***	0.832***
	(0.00642)	(0.00645)
Adviser Controls	X	X
Year F.E.		X
Complete Spells		
Observations	1,357,046	1,357,046

What types of firms do advisers switch to?

	Avg. Payout	No. Social Links	Misc. Rate	Firm Size	Assets ($bn)	Rev. ($mm)
Misconduct	-14,690***	-12,477***	0.00532***	-1,898***	-36.76***	-391***
	(3,567)	(3,361)	(0.000577)	(230.2)	(4.82)	(41)
Orig Firm × Year F.E.	X	X	X	X	X	X
Observations	69,051	32,588	456,949	456,949	75,393	75,088
R-squared	0.002	0.002	0.007	0.002	0.000	0.003

Misconduct in the market

- Why does misconduct survive?
  - ▸ Misconduct is publicly observable
  - ▸ Adviser and firm misconduct
  - ▸ Why doesn't reputation drive out bad advisers / firms?
  - ▸ Why don't advisers compete on quality?

- Heterogeneity in consumer sophistication
  - ▸ Stahl (1989) model of search w/ twist
  - ▸ Sophisticated observe misconduct
  - ▸ Unsophisticated do not
  - ▸ Generates equilibrium dispersion of adviser quality

| | Misconduct Rate | |
	(1)	(2)
Retail Investors	0.0332***	0.0340***
	(0.0107)	(0.0108)
Firm Controls		X
Year F.E.		X
State F.E.		X
Observations	1,136	1,125
R-squared	0.179	0.319

Consumer Sophistication
Variation Across Counties

Table: Counties with Highest and Lowest Rates of Misconduct

(a) Highest Incidence

Rank	County	Rate	# Advisers
1	Madison, NY	32.06%	131
2	Indian River, FL	19.15%	282
3	Guaynabo Municipio, PR	19.05%	126
4	Monterey, CA	18.39%	397
5	Martin, FL	18.38%	357
6	Palm Beach, FL	18.11%	5,278
7	Richmond, NY	17.66%	436
8	Suffolk, NY	17.28%	4,136
9	Bay, FL	16.98%	106
10	Lee, FL	16.76%	853

(b) Lowest Incidence

Rank	County	Rate	# Advisers
1	Franklin, PA	2.63%	114
2	Saline, KS	2.68%	112
3	Cerro Gordo, IA	2.68%	112
4	Kenton, KY	2.86%	1,991
5	Washington, VT	3.05%	197
6	Bronx, NY	3.10%	226
7	Rutherford, TN	3.10%	161
8	Stearns, MN	3.26%	491
9	Ottawa, MI	3.52%	312
10	Boone, MO	3.78%	159

Consumer Sophistication and Misconduct
Variation Across Counties

$$Misconduct\_Rate_{js} = \beta X_{js} + \mu_s + \varepsilon_{js}$$

| | Misconduct Rate | | | |
| | Current and Past Misconduct | | Current Misconduct | |
	(1)	(2)	(3)	(4)
ln(pop)	-0.000548	-0.000865	-3.84e-05	0.000107
ln(inc)	0.0412***	0.0431***	0.00275*	0.00627***
Pct Rural	-0.0458***	-0.0340**	-0.00529***	-0.00482**
Pct College	-0.0817**	-0.0774**	-0.00898***	-0.0126***
Pct 65 or Older	0.296***	0.271***	0.0260***	0.0242***
Labor Force Part.	-0.165***	-0.0525	-0.0216***	-0.0168**
Year F.E.		X		X
State F.E.		X		X
Observations	2,607	2,607	2,607	2,607
R-squared	0.214	0.393	0.065	0.172

- How do differences arise?

- Firm differences in misconduct tolerance?

- More misconduct
  - ▸ Less likely to fire following new misconduct
  - ▸ Larger share of new hires has past record

- Control group for labor market outcomes
  - Advisers from firm x county x year
  - Better / worse than average?

- Dissolved firms
  - Control group = all employees

- Quantitatively and qualitatively similar results

Robustness

- Other disclosure categories predict misconduct
  - Consumer disputes (Denied, Withdrawn, Closed-No Action)
  - Judgment / Lien
  - Financial - Final

- Measurement:
  - Severe Misconduct
  - Client facing advisers (Sokobin et al)

- Brokers v/ investment advisers

- Customer vs. non-customer initiated claims

- Industry exit (5 years)

Conclusions

- Misconduct prevalent
  - 1 in 13 advisers has been disciplined for misconduct
  - 20% at some of the largest and most prominent firms in the US
  - Repeat offenders
  - Large differences across firms

- Strict discipline w/in firms
  - 50% switch firms (2.5 × mean rate)
  - More fraudulent firms are less strict

- Market for financial adviser misconduct
  - 40% re-hired
  - Move to smaller and lower paying firms
  - Longer unemployment spell

- Consistent with some firms choosing to target susceptible clients
  - Misconduct is higher among areas with older, wealthier, less educated individuals

Misconduct Complaints

Reasons for Complaint	Frequency
Unsuitable	21.29%
Misrepresentation	17.69%
Unauthorized Activity	15.07%
Omission of Key Facts	11.61%
Fee/Commission Related	8.67%
Fraud	7.89%
Fiduciary Duty	6.48%
Negligence	5.83%
Risky Investments	3.72%
Churning/ Excessive Trading	2.58%
Other	42.52%

Product	Frequency
Insurance	13.81%
Annuity	8.55%
Stocks	6.04%
Mutual Funds	4.60%
Bonds	1.93%
Options	1.20%
Other/Not Listed	69.90%

Alternative Misconduct Classification

Create new category *"Severe Misconduct"* as

Any settled regulatory, civil, or customer dispute involving

- Unauthorized activity
- Fraud and forgery
- Churning
- Selling unregistered securities
- Misrepresentation
- Omission of Material/Key Facts

As well as finalized criminal cases involving:

- Investment (including checking account) related activities
- Fraud and forgery

Disclosure	Disclosure/Misconduct	
	Current	Current and Past
Any Disclosure	1.62%	12.74%
Misconduct	0.603%	7.28%
Severe Misconduct	0.241%	2.91%

Main results robust to the Severe Misconduct classification

- Past misconduct predicts future misconduct

- Firm and industry consequences of misconduct
  - 19pp more likely to leave firm
  - 10pp less likely to find new employment

Rank	Firm	Firm CRD#	Misconduct Rate	# Advisers
1	OPPENHEIMER & CO. INC.	249	28.22%	1,453
2	FIRST ALLIED SECURITIES, INC.	32444	24.22%	677
3	RAYMOND JAMES & ASSOCIATES, INC.	705	22.23%	2,973
4	CETERA ADVISORS LLC	10299	19.49%	857
5	SECURITIES AMERICA, INC.	10205	19.00%	1,484
6	NATIONAL PLANNING CORPORATION	29604	18.94%	1,019
7	WELLS FARGO ADVISORS FIN. NETWORK	11025	18.57%	1,384
8	UBS FINANCIAL SERVICES INC.	8174	18.38%	9,522
9	STIFEL, NICOLAUS & COMPANY, INC.	793	18.31%	2,720
10	JANNEY MONTGOMERY SCOTT LLC	463	17.72%	999

$$Sep_{ijlt} = \alpha_0 Misc_{ijlt-1} + \alpha_1 Firm\,Misc_{jt-1} * Misc_{ijlt-1} + \beta X_{it} + \mu_{jlt} + \varepsilon_{ijlt}$$

	(1)	(2)	(3)
Misconduct	0.312***	0.331***	0.274***
	(0.0189)	(0.0174)	(0.184)
Firm Misconduct	2.786***	3.057***	
	(0.406)	(0.372)	
Misconduct × Firm Misconduct	-2.843***	-3.104***	-1.312***
	(0.408)	(0.368)	(0.111)
Adviser Controls	X	X	X
Year×Firm×County F.E.			X
Observations	7,278,974	7,278,974	7,241,162
R-squared	0.009	0.017	0.345

$$Share\_of\_New\_Hires\_Disciplined_{jt+1} = \beta_0 + \beta_1 Firm\_Misconduct_{jt} + \mu_s + \mu_t + \varepsilon_{jt}$$

	(1)	(2)	(3)
Misconduct Rate	0.379***	0.373***	0.364***
	(0.0565)	(0.0563)	(0.0555)
Year F.E.		X	X
State F.E.			X
Observations	17,847	17,847	17,847
R-squared	0.044	0.045	0.052

Trust Barometer

How much do you trust the following industries to do what is right?

Industry	
Technology	79%
Automotive	66%
Food and Beverage	64%
Consumer Packaged Goods	62%
Telecommunications	60%
Brewing and Spirits	59%
Pharmaceuticals	56%
Energy	53%
Media	51%
Banks	47%
Financial Services	45%

Source: 2012 Edelman Trust Barometer®